



STEP UP AND ACE THE CFA® EXAMS

Follows CFA Institute Prep Provider Guidelines

Level III - Ethical and Professional Standards in Practice

Application of the Code and Standards

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A Framework for Ethical Decision Making

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- Identify Potential Conflicts of Interest
- Identify Applicable Ethical Principles
- Consider Seeking Additional Guidance
- Consider Circumstances That Could Be Affecting Judgment
- Consider Alternative Actions
- Act and Review the Outcome

The Consultant

- Mark Vernley's Background
 - Petroleum engineer
 - Securities analyst
 - Own consulting firm
- The Consulting Contract
 - Client is Highridge Oil Pipeline
 - Proposed profit sharing with oil companies
 - Plains Pipeline Systems claims that plan is flawed because Vernley has a conflict of interest

The market value and composition of his current portfolio is as follows:

Deepwell Explorations	\$250,000
National Marketing and Refining	50,000
Integrated Energy Resources	45,000
Highridge Oil Pipeline	50,000
Interplains Gas Pipeline	75,000
Logline Well Service	35,000
Subtotal	\$505,000
Shares in other industries	475,000
Total portfolio	\$980,000

Framework for Ethical Decision Making

- Identify the Important Facts and Issues
- Identify Others to Whom Duties are Owed
- Identify Potential Conflicts of Interest
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- Consider Seeking Additional Guidance
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Vernley can deal with conflicts of interest in two ways...

- Avoidance
 - Extreme case: avoid investments in energy-related investments
 - Blind trust
 - Mutual fund specializing energy-related issues
- Disclosure
 - At a minimum, Vernley must disclose to clients of Energetics the existence and the nature of any conflict of interest surrounding a consulting assignment. Vernley must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

A Plan for Energetics

- Culture and Leadership
- Communication
- Education

Procedures for Compliance

Companies should have written documents that spell out their compliance procedures. A company can document several measures that are aids in managing its compliance program effectively, including:

- Annual certification by employees that they have maintained familiarity with the standards and agree to abide by them
- For the purpose of detecting conflicts of interest or insider trading, required reporting by employees, at least quarterly, of all securities transactions for their own personal accounts or those in which they have a beneficial interest
- Disclosing to management the existence and nature of any possible or actual compensation from sources other than the employer
- Certification by employees that they have not entered into an independent business activity in competition with their employer. The purpose of this measure is to protect the firm from, for example, misappropriation of trade secrets, misuse of confidential information, solicitation of customers prior to cessation of employment, or self-dealing; and
- Employee memberships in organizations that maintain standards required for the practice of their professions—for example, continued affiliation by Energetics’s engineers with the association of professional engineers.

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PEARL INVESTMENT MANAGEMENT (A)

After obtaining an M.B.A. in finance, Peter Sherman is offered a position as an account manager with Pearl Investment Management, an investment counseling firm specializing in equity portfolio management for pension and profit-sharing funds, endowment funds, and high-net-worth individuals' accounts. Sherman begins work in the firm's back office, handling administrative tasks for his assigned accounts, settling transactions, balancing the accounts to bank records, and ensuring that client guidelines are followed.

Pearl is a large firm with a number of different departments, including account administration, research, and portfolio management. Having its own research staff allows Pearl to temper its reliance on brokerage firm research, to weigh its conclusions against the opinions of others, and to perform security analysis on companies that are not well followed for Pearl's proprietary use in client portfolio recommendations.

Many of the portfolio managers and analysts at Pearl are CFA charterholders, and as a result, the firm has adopted the CFA Institute Code of Ethics and Standards of Professional Conduct as part of its policy for internal compliance. The firm policy manual also contains excerpts from laws and regulations that govern investment advisors such as Pearl (and its employees), including sections from the U.S. Securities Act of 1933, the U.S. Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the National Association of Securities Dealers manual. All employees must read and sign a statement when they join the firm that they have read Pearl's policies and must repeat this procedure at the beginning of each subsequent year as a reminder of their compliance responsibilities. On Sherman's first day on the job, his department head gives him the policy manual as part of his orientation program, requests that he read it during the day before signing the compliance statement, and advises him that the firm's compliance department will answer any questions he may have. Sherman reads through the manual quickly and then signs the company's personnel policies statement.

I (A) – Knowledge of the Law

III (A) – Loyalty, Prudence and Care

III (B) – Fair Dealing

IV (A) – Duties to Employers: Loyalty

IV (C) – Responsibilities of Supervisors

VI (B) – Priority of Transactions

After a few months, Sherman feels comfortable handling the administrative tasks related to the client accounts he manages at Pearl and ensuring that client investment guidelines are being followed. He enjoys the challenges of being the account manager for his (and Pearl's) clients, the close access to investment information and strategies, and the opportunity to invest his savings with greater insight and understanding than he had before this job. Previously, his personal investments had been in no-load mutual funds, but in his new position, he sees that he can achieve greater reward by building a portfolio of his own. To further this goal, Sherman reads books about investments and portfolio strategy, as well as the company summaries generated by the firm's research department, and he follows the daily price changes of the firm's major holdings. He enjoys discussing his new-found knowledge with family and friends. To put his new knowledge to work in his own portfolio, Sherman decides to open an account with a national discount broker and purchase a few of the stocks that are Pearl's largest equity positions.

I (A) – Knowledge of the Law

III (A) – Loyalty, Prudence and Care

III (B) – Fair Dealing

IV (A) – Duties to Employers: Loyalty

IV (C) – Responsibilities of Supervisors

VI (B) – Priority of Transactions

PEARL INVESTMENT MANAGEMENT (A) Policy Statements

Knowledge of the Law

“Supervisors shall exercise reasonable supervision over those employees subject to their control and shall monitor all actions of employees in their charge to determine that the firm’s policies are being followed and to prevent any violation by such persons of applicable statutes, regulations, or provisions of the Code of Ethics and Standards of Professional Conduct. Supervisors shall review the contents of the compliance manual with all direct charges when they are hired and answer any questions or concerns the employees may have.”

Responsibilities of Supervisors

“Employees shall submit personal trades to the compliance department for approval in advance of any personal investment action in order to clear the trades against client transactions. In the event that an employee wishes to transact in securities that are being traded for clients, the employee will be allowed to trade only after all client transactions have been processed, the compliance department has approved the request, and a 24-hour moratorium has expired. On a monthly basis, all personal trades (as shown on brokerage statements of account) must be submitted to the compliance department for review.”

PEARL INVESTMENT MANAGEMENT (A) Policy Statements

Conveying Confidential Client Information

“Proprietary information shall not be communicated outside the firm. ‘Proprietary’ includes information about client portfolios, investment strategies, and portfolio actions and recommendations. Furthermore, employees should be mindful of the special relationship with Pearl’s clients and ensure that the highest degree of care is preserved when investment action is taken on their behalf.”

PEARL INVESTMENT MANAGEMENT (B)

Competition for the infrequent job openings at Pearl Investment Management is extensive, both from within the firm and from the outside. After a year in Pearl's back office as one of the account managers, Peter Sherman is told that obtaining a CFA charter would greatly enhance his chances of moving into the firm's research area. Sherman studies at length and passes Level I of the CFA exam.

In the next year, Sherman is helpful in clearing up problems related to the allocation of block trades among certain large client accounts. The most difficult problem is a misallocation related to an initial public offering (IPO) of Gene Alteration Research Corporation. Sherman was assigned this project because of his accounting experience and because none of his client portfolios was involved, although most of his institutional accounts and a few of his larger individual accounts are "total rate of return" portfolios.

PEARL INVESTMENT MANAGEMENT (B)

Because his review is a rush project, Sherman does not have time to consult the clients' investment policy statements, but he feels certain that the portfolio managers would direct only trades suitable to their client accounts. Furthermore, he believes the trading desk would have acted as a second review for client investment guidelines. Sherman reconciles the transactions related to the block trades across all the portfolios in question. As a result, certain securities are shifted among accounts. Sherman believes that with the adjustments and with the transactions reversed and reallocated at the IPO price for the Gene Alteration issue, all clients have been treated fairly, but he wonders how the problems arose in the first place.

- I (A) – Knowledge of the Law
- III (A) – Loyalty, Prudence and Care
- III (B) – Fair Dealing
- IV (A) – Duties to Employers: Loyalty
- IV (C) – Responsibilities of Supervisors
- VI (B) – Priority of Transactions

Responsibility of Candidates to Comply with the Code and Standards

PEARL INVESTMENT MANAGEMENT (B) Policy Statements

Dealing with Clients

“Employees owe a duty of loyalty, prudence and care to clients, and in all instances, the interests of clients shall come first. Action contrary to this policy is expressly prohibited. Allocation of trades shall be on a fair and equitable basis for all portfolios with similar investment objectives and constraints.”

Bearing the Financial Risk of Errors in Client Accounts

“The firm will take all steps necessary to ensure the integrity of its client accounts. When errors do occur, the clients’ portfolios will be restored with no loss of value to the client. To the extent that such losses occur, Pearl will indemnify its clients and make the appropriate restitution.”

PEARL INVESTMENT MANAGEMENT (C)

After Peter Sherman passed Level II of the CFA exam, Tomas Champa, Pearl Investment Management's director of research, requested that Sherman be transferred to the research department with the understanding that his apprenticeship in the department as a junior analyst would last at least until he was awarded the CFA charter. Sherman was thrilled at the prospect of moving into research, and he accepted the transfer. Champa came to Pearl when he decided to remain in the United States after completing a five-year U.S. tour of duty for a major international bank with which he had served for 20 years. His background in international banking has made him particularly well suited to be the research director at Pearl.

Champa has seven analysts in his department—five senior analysts and two junior analysts. Sherman is one junior analyst, and the other is a Level III CFA candidate. Champa is anxious to lead the firm's research efforts into international securities and wants to begin with companies in the developing countries whose markets have experienced spectacular performance in recent years. He tells the analysts that Pearl must come up with research recommendations in emerging market equities quickly or the department will face criticism from senior management and the firm's clients. He also wants to be able to attract prospective clients by demonstrating the firm's expertise in this area.

I (C) – Misrepresentation

II (A) – Material Nonpublic Information

IV (A) – Duties to Employers: Loyalty

IV (C) – Responsibilities of Supervisors

V (A) – Diligence and Reasonable Basis

V (B.2) – Communication with Clients and Prospective Clients

Although Sherman is new to the department, Champa gives him difficult assignments because he believes Sherman's lack of preconceived notions about emerging market companies makes him an ideal analyst for this area. Sherman is to concentrate on Central and South America, areas where Champa believes he has special insight and can direct Sherman. Sherman reads several brokerage reports on Latin American markets, spends time with Champa and other members of the research department discussing trends in these markets, and browses through the statistical section of Standard & Poor's International Stock Guide. For a briefing by someone with actual experience, Champa refers Sherman to one of his old banking contacts, Gonzalo Alves, who is well connected in Mexico and on the board of directors of a number of important Mexican corporations. Sherman spends several hours speaking with Alves about the Mexican economy and the companies for which Alves serves as a director. Alves tells Sherman about the strategic direction of each company, some potential acquisition targets, and how changes in the Mexican economy will affect each company directly. Sherman now feels comfortable using this information in writing his research reports. Champa asks Sherman to produce a research report on several Mexican telecommunications and cable companies.

I (C) – Misrepresentation

II (A) – Material Nonpublic Information

IV (A) – Duties to Employers: Loyalty

IV (C) – Responsibilities of Supervisors

V (A) – Diligence and Reasonable Basis

V (B.2) – Communication with Clients and Prospective Clients

Because of the deadline Champa gives Sherman for the report, Sherman cannot develop the research easily on his own, so he plans to incorporate information from his reading of the brokerage firm reports, his conversation with Alves, and other sources. Sherman hastily finishes his two-page report, “Telecommunications Companies in Mexico,” which includes excerpts from the brokerage reports, general trends and ratios from the S&P International Stock Guide, and paraphrased opinions from Alves. It concludes with an internal recommendation that stock in the Mexican telecommunications companies be bought for Pearl clients for which such stock is suitable. Sherman does not cite the brokerage reports as sources because they are so widely distributed in the investment community. Pearl’s upper managers applaud Champa and his staff for their quick response to the market demand for emerging market research, and the portfolio managers ask the research department for more recommendations. Jill Grant, however, the other junior research analyst, asks Sherman why his report did not include specific details about the Mexican economy or the historical exchange rate fluctuations between the Mexican peso and the U.S. dollar. She questions the comparability of Mexican securities with U.S. securities and notes that the diversification available from investing in global markets is achieved only if the correlation between the specific non-U.S. market and the U.S. market is low. Sherman’s response, supported by Champa, is, “Our clients are sophisticated investors; they know these things already.”

I (C) – Misrepresentation

II (A) – Material Nonpublic Information

IV (A) – Duties to Employers: Loyalty

IV (C) – Responsibilities of Supervisors

V (A) – Diligence and Reasonable Basis

V (B.2) – Communication with Clients and Prospective Clients

PEARL INVESTMENT MANAGEMENT (C) Policy Statements

Proper Care and Independent Judgment

“Analysts shall use proper care and exercise independent professional judgment in the preparation of research reports to ensure that reports are thorough, accurate, and include all relevant factors.”

Use of Insider Information

“Analysts and portfolio managers are prohibited from using material nonpublic information in any form in making investment recommendations or taking investment action. Any employees who have come into possession of material nonpublic information (or who believe they have) shall contact the compliance department or compliance officer for guidance. If the information is determined to be material nonpublic information, the employee must refrain from acting on it and should take steps to disseminate the information publicly.”

PEARL INVESTMENT MANAGEMENT (C) Policy Statements

Using Research of Others

“Analysts are prohibited from using the work of others without reference and are prohibited from plagiarizing the work of others by not giving due credit to the author, whether or not the author is employed by the firm.”

Reasonable Basis for a Research Opinion

“All relevant factors, including the basic characteristics involved in the investment, are to be included in a research report, with a corresponding discussion of the potential risks involved.”

Relevant Factors and Fact Versus opinion in Research Reports

“Employees shall make only those statements, either verbally or in writing, about the firm and its qualifications that represent the firm properly and with the integrity it has tried to achieve. The firm shall not solicit clients, new or existing, for a new investment style without full disclosure of the firm’s qualifications and expectations for both risk and potential return. Performance results for a new investment style will be in compliance with Standard III(D)—Performance Presentation, as discussed in the CFA Institute Standards of Practice Handbook.”

Conclusion